

Internal Revenue Service
memorandum

CC:TL-N-6994-88

Br4:JRDomike

date: JUN 27 1988

to: District Counsel, Greensboro SE:GBO

from: Director, Tax Litigation Division CC:TL

subject:

Pre-90 Day Case

This responds to your June 8, 1988 request for technical advice on the proposed statutory notice of deficiency.

CONCLUSION

We recommend a single notice of deficiency including alternative determinations of income tax deficiencies and penalties for all the years involved. As there is a preliminary issue to be decided--whether the organization is a taxable corporation, or exempt and subject only to tax on unrelated business income--the Service in order to protect the revenue should make alternative determinations pursuant to the relevant Code sections and regulations, even though the resulting deficiencies differ in amount. As the Service has issued a revocation letter, the first alternative determination should be for the organization as a taxable corporation.

ISSUE

The issue concerns the proper format for a notice of deficiency where the primary position must be asserted for policy reasons even though the alternative position generates larger deficiencies in tax, as well as additions to the tax, than those determined under the primary position. The primary position is that the taxpayer is a taxable corporation; the alternative position is that the taxpayer is an exempt organization taxable on unrelated business income. The issue you raise is whether the alternative position should be "folded" into the primary position or, on the other hand, stated separately in the notice of deficiency.

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FACTS

Background

█████ was recognized May 17, 1973 by the Internal Revenue Service under sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code as an organization entitled to exemption from federal income tax to which charitable contributions would be deductible. Although the Service did not recognize █████ under sections 509(a)(1) and 170(b)(1)(A)(i), █████ held itself out to be a church not required to file annual returns (Form 990) and it did not. See I.R.C. § 508(c) and § 6033(a)(2). Therefore, there is no statute of limitations on assessment. I.R.C. § 6501(c)(3).

On October 25, 1985, the Atlanta Key District office issued a Revenue Agent's Report covering the tax periods █████-█████. The RAR for █████ through █████ is dated March 30, 1988. As a result of these examinations, the Service revoked █████'s exemption by letter dated April 22, 1988. █████ filed a declaratory judgment suit █████ in the U.S. Claims Court challenging the revocation.

Previously, on █████, █████ filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. On █████, the Government filed two proofs of claim in this proceeding, one premised on revocation of █████'s tax-exempt status, the other on unrelated business income tax of an exempt organization. █████ has challenged the revocation, as well as the claims, in the Bankruptcy Court. The Bankruptcy Court has allowed the claim "in an amount to be determined."

The RAR's identify inurement to individuals and other persons. It is expected that notices of deficiency will be issued to those individuals and other persons. The subject statutory notice is expected to be issued at that time to protect the interests of the Government.*

Proposed Notice

The proposed notice determines deficiencies in corporate income tax computed under I.R.C. § 11 and the additions to the tax based upon the revocation of █████'s tax-exempt status (primary position).

The alternative position is not mentioned in the proposed notice but attached to it; it contains separate tax computations, explanatory paragraphs, and exhibits.

* Coordination with all affected functions should be had before the statutory notice is actually issued.

The principal items of income, i.e., [REDACTED] controlled entities and prepaid revenue, overlap in both the primary and alternative positions. Other items of income and allowable expenses are, however, different with respect to each position. The principal difference in the alternative position is that a lesser amount of expenses were allocated to this position in the deficiency notice, thereby producing larger or greater tax deficiencies than under the primary position.

Your Alternative Recommendations

1. Proposed solution: To "fold" the alternative position into the primary position.

You propose to "fold" the alternative position into the primary position, thereby broadening out the primary position in the deficiency notice to include the net income from [REDACTED]'s unrelated trades or businesses. You would expand the principal explanatory paragraph concerning [REDACTED]'s revocation by adding the reasons therefor in detail, plus the following:

In this connection, it has been determined that [REDACTED] has net unrelated trade or business income for the taxable years ended [REDACTED], [REDACTED], [REDACTED], and [REDACTED] in the amounts of \$ [REDACTED], \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED], respectively, as fully set forth and explained in the notice of deficiency beginning at page * thereof. Moreover, the [REDACTED] organization failed to file Forms 990T, as required by I.R.C. §§ 511 through 513 and § 6012 with respect to said income and the organization failed to pay any tax with respect thereto.

You would include this language in the primary position without separate tax computations. The alternative position attachment would be relabeled as "Unrelated Trade or Business Income" and the §§ 511-513 tax computations would be deleted from the deficiency notice thereby removing any contention that the Commissioner has made two deficiency determinations. You note that at the time of the answer in Tax Court, respondent could plead in the alternative that "if it is determined that [REDACTED] is exempt from tax under the provisions of I.R.C. § 501(c)(3) for some or all of the taxable years involved, then the deficiencies in tax based upon the unrelated trade or business income as set forth and explained in the deficiency notice as a reason for

revocation or the failure of [REDACTED] to qualify as an exempt organization, are as follows: § [REDACTED] for the taxable year ended [REDACTED], "et seq. You expect that this modified and expanded approach would place the burden of proof upon the taxpayer as to the amounts of the unrelated trade or business income inasmuch as this item now becomes a basis for revocation and/or the failure of [REDACTED] to qualify as an exempt organization, which is the Commissioner's primary position. The respondent's burden of pleading and proof should only be computational in nature concerning the deficiencies in tax and the additions to the tax with respect to the unrelated income.

2. Alternative solution: to include the alternative position in the deficiency notice.

You state that if our office decides that the alternative position can be stated separately in the deficiency notice without adverse consequences, you suggest that, after the first explanatory paragraph concerning the primary position that [REDACTED] does not qualify as an exempt organization, the following paragraph or one of similar import be inserted:

The taxable income shown herein and on the attached exhibits due to the revocation of your tax-exempt status under the provisions of I.R.C. § 501(c)(3) includes the income from unrelated trades or businesses, which has been determined, in the alternative, to be taxable under the provisions of I.R.C. §§ 511 through 513, as more fully set forth and explained under the alternative position beginning at page _____ of this notice of deficiency.

The alternative position would contain the separate tax computations, explanatory paragraphs, and exhibits.

We agree with this procedure, except that we would add the following to the above explanatory paragraph: "if it is determined that you are exempt from tax under the provisions of I.R.C. § 501(c)(3) for some or all of the taxable years involved."

DISCUSSION

Section 6212(a) provides, "If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitle A or B or chapter 41, 42, 43, 44. or 45, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail." For our purposes, the relevant language is, "If the Secretary determines that there is a deficiency in ... tax ... he is authorized to send a notice of such deficiency to the taxpayer"

In this case, the classification of the taxpayer is also at issue, and the correct determination depends upon the correct identification of the taxpayer. Therefore, it behooves the Commissioner to protect the revenue by making two, that is, **alternative deficiency determinations**, giving the **taxpayer adequate** prior notice in the notice of deficiency, while **recognizing** that the notice is being given when the taxpayer's **taxpaying** status has yet to be decided. This factual pattern--which could be a common occurrence in contested revocations of exempt organizations--has not to our knowledge surfaced before. The question here is what is the best way to give this notice.

We agree with you that the proposed notice as it stands is not adequate. We do not think that the preferred solution is No. 1 above, because we believe that in the answer in the Tax Court respondent would be affirmatively alleging the higher deficiencies and additions to the tax as determined in the RARs for the exempt organization. At the very least, respondent would be asking for an increased deficiency over the one determined in the notice. See I.R.C. § 6214(a); T.C. Rule 141(a). As you suggest in your memorandum at page 10, "the alternative position is not simply another reason in support of the primary position, but is a separate and distinct determination of its own." Horvath v. Commissioner, 59 T.C. 551, 556-557 (1973), stands for the proposition that notice to the taxpayer is the principal purpose served by the notice of deficiency, and that broadest possible notice should be given in the notice of deficiency. In our view, "broadest possible notice" includes the alternative determination of deficiency in this case.

Therefore, we believe that two determinations must be made in the notice of deficiency, in the alternative, with the taxable corporation determination asserted first. See No. 2 above. We believe that the objectives suggested in your memorandum at page 6 will be served by following this procedure. Respondent will retain the presumption of correctness as to the first determination and will also retain presumption of correctness as to the alternative determination. Also the burden of proof will remain on the taxpayer in all eventualities. We believe we can achieve these intended objectives without impairing the validity of the deficiency **notice** and without taking the burden of pleading or proving in **some** manner the deficiencies (or the excess portion thereof) **determined** under the alternative position.

In Olsen v. Helvering, 88 F.2d 650, 651 (2d Cir. 1937), Judge Learned Hand stated that "the notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough." Relying on this, the Tax Court said, "In other words,

the notice must (1) fairly advise the taxpayer that the Commissioner has, in fact, determined a deficiency and (2) specify the year and amount." Foster v. Commissioner, 80 T.C. 34, 229-230 (1983).

In this case, the identity and classification of the taxpayer is initially at issue: it may be a taxable corporation, or it may be a tax-exempt entity with unrelated business income. While the Service is amply justified to protect the revenue by issuing two inconsistent determinations, in fact, only one determination is relevant: which one will be determined by the outcome of the revocation issue. Once the taxpayer is unequivocally identified, then there will be only one unequivocal determination; and the other one will simply be surplusage. As you noted, both positions, standing alone, are not conflicting inasmuch as the respondent is not seeking to tax the net income more than once under either theory.

The burden of proof will be on the taxpayer in Tax Court--first, on the revocation issue, and then on the relevant deficiency determination. If the Claims Court or the Bankruptcy Court has decided the revocation issue, then the Tax Court will only consider the relevant deficiency determination.

If the taxpayer fails to file a petition in the Tax Court, you ask if the Service would be entitled to assess the larger deficiencies and additions to the tax determined under the alternative determination.

As is discussed above, the first issue to be decided is the taxpayer's taxpaying status. If that has not been decided by the Claims Court or the Bankruptcy Court when the notice here discussed is issued and defaulted, then the Commissioner, to protect the revenue, should assess the larger deficiencies and additions to the tax determined under the alternative determination.

You ask, if the Service simultaneously asserts both the primary and alternative positions in its notice of deficiency, has the Commissioner really made an unequivocal "determination" of a deficiency for purposes of I.R.C. § 6212(a)? Or has he made two different determinations resulting in two separate and distinct deficiencies and, therefore, has not made a determination? Reference is made to Scar v. Commissioner, 81 T.C. 855, 860-861 (1983), rev'd, 814 F.2d 1363 (9th Cir. 1987). You suggest that because Scar holds that the Service did not make "a determination," it raises the question in this case whether the notice of deficiency we recommend will make "a determination" (because it makes two alternative determinations).

It is our view that Scar concerns totally different facts, a distinctly different notice of deficiency problem, and a different notice of deficiency from the one proposed herein, and therefore Scar cannot control.

Further, as we have indicated, it is our view that the Service must make alternative determinations in this case, to protect the revenue, and to give the taxpayer a complete and timely notice in the notice of deficiency which takes into account the contested issue of the taxpayer's taxpaying status.

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